

No. 10,253

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

SECTION SEVEN CORP.

(a corporation),

Appellant,

vs.

CLIFFORD C. ANGLIM, Collector of Internal Revenue for the First District of California,

Appellee.

APPELLANT'S OPENING BRIEF.

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I.

JURISDICTION.

This is a proceeding to review a decision of the United States District Court for the Northern District of California Southern Division, dated April 24, 1942 and filed and entered April 27, 1942, adjudging and decreeing that appellant is not entitled to recover from appellee the sum of \$1051.00 capital stock taxes paid for the taxable year commencing July 1, 1938 and ending June 30, 1939.

Appellant filed its capital stock tax return for said year and paid said amount to appellee on August 30,

1939. On November 18, 1939, a claim for refund was filed on the ground that petitioner was not carrying on or doing business during the year and was therefore not subject to the declared value excess profits tax imposed under the provisions of Sections 1200 to 1207 of the Internal Revenue Code of 1939, as amended. The Commissioner of Internal Revenue rejected said claim on February 19, 1940 and gave written notice of such rejection, as provided by Statute. Suit was filed in the District Court against appellee for said amount on September 23, 1940. (Complaint R. 2 to 4, Answer R. 5.)

Jurisdiction of the District Court is sustained by Section 24, subdivisions 5 and 20 of the Judicial Code as amended, Title 28 U.S.C.A. Section 41.

Jurisdiction of this Court to review the decision of the District Court of Appeals is sustained by subsection a-1 of Section 128 of the Judicial Code as amended, Title 28 U.S.C.A. Section 225.

II.

STATEMENT OF THE CASE.

Appellant was incorporated November 19, 1937 under the laws of the State of California for the purpose of acquiring the interests of certain tenants-in-common in and to Section 7, Title 20 South, Range 16 East, M. D. B. & M., Fresno County, California.

In the year 1911 legal title to this property was vested in the Mercantile Trust Company by the then

owners. The trust company was to dispose of the property, which was prospective oil property, in accordance with the directions of a committee of the owners. (R. 15.)

Prior to 1937 every member of the committee had died and a majority of the owners had died. As a result, the equitable title to the property had become involved. (R. 15.)

In 1937 Seaboard Oil Company of Delaware offered to lease the property for the purpose of drilling for oil. It was necessary to clear title to the property by partition through Court action. (R. 58.)

Appellant was formed to acquire the interests of the owners as determined in the partition suit and to execute an oil lease to the Seaboard Oil Company of Delaware. Owners of an undivided five-sixths interest in the land conveyed their interests in the land to the corporation; the corporation executed an oil lease toward the end of the year 1937 covering one-half of the land and commenced the partition proceeding. As a result of the partition suit, the property was partitioned in kind and the corporation acquired five-sixths of Section 7, and one-sixth was partitioned to an owner, who did not convey his interest in the land to the corporation. (R. 58-59.)

For and in consideration of the transfer of the interests of the owners in the property to appellant, appellant issued 530 shares of its capital stock. (R. 59.)

On June 3, 1938, the lease of one-half the land previously executed was cancelled and a new oil lease was

executed by which the entire five-sixths interest in the property acquired by appellant was leased to the Seaboard Oil Company of Delaware. (R. 59.) This lease is plaintiff's exhibit No. 1. (R. 16 to 39.)

Under the provisions of said lease, appellant was entitled to receive a royalty on all oil produced equal to one-sixth of its value and one-sixth of the net proceeds of all gas produced and sold. The lease gave lessor the option to receive the oil royalty in oil delivered in tanks on the leased premises provided sixty days' notice of the exercise of the option was given and provided further that the option could be exercised only once in any one year. (Section 1 of Exhibit A.—R. 19; Finding II, R. 9.) In the absence of the exercise of this option, the royalty was payable in cash.

Drilling was done pursuant to the terms of this lease; oil was found in September 1938, and appellant received the first royalty in October 1938. Oil continued to be produced and by June 30, 1939, appellant had received oil royalties of \$29,409.29 and gas royalties of \$22.35. (R. 54, Finding III, R. 10.)

Appellant received no other income, save a nominal sum for rights-of-way granted pursuant to a custom of the oil industry and in order to avoid condemnation proceedings. (Finding III—R. 10; R. 56, R. 58.)

Although appellant had an option to receive oil in kind, this option was never exercised. At no time during the meetings of the Board of Directors was there ever any discussion respecting the exercise of the option to take royalties in kind. The question never arose and nothing has been done by the corporation

except to receive the cash royalty. (R. 57-58.) The royalties received were distributed in the form of dividends to the shareholders and no further or other corporate activity other than as outlined above was engaged in. (R. 56—Finding V—R. 10.) The corporate activity of appellant was exercised through its officers and Board of Directors. It had no regular employees and its expenditures consisted of miscellaneous expenses for telephone, office supplies, taxes, and fees of accountants and attorneys. (Finding V, R. 10.)

The corporation was formed solely for the purpose of acquiring title to the property, executing an oil lease and thereafter receiving royalties and distributing these royalties in the form of dividends to the shareholders of the corporation. (R. 59.)

Appellant filed its capital stock tax return for the taxable year commencing July 1, 1938 and ending June 30, 1939, and paid a tax of \$1051.00 to appellee on August 30, 1939. A claim for refund was filed on the ground that appellant was not carrying on or doing business during the taxable year, and denied by the Commissioner of Internal Revenue, and thereafter suit was brought for the recovery of the amount of the tax. (Finding IV, R. 10.)

The sole ground upon which the District Court held that appellant was carrying on or doing business during the taxable year in question was that under the terms of the lease with the Seaboard Oil Company of Delaware, plaintiff's Exhibit No. 1, appellant had an unexercised right, once in any calendar year, to demand an oil royalty in kind rather than in cash. (R. 10-11.)

III.

STATEMENT OF ERRORS RELIED UPON.

The District Court erred in:

1. Holding and deciding that appellant was carrying on or doing business during the tax year ending June 30, 1939.

2. Holding and deciding that appellant was subject to the payment of the declared value capital stock tax imposed by Section 1200 of the Internal Revenue Code of 1939 as amended for the year commencing July 1, 1938, and ending June 30, 1939.

3. Holding and deciding that the sum of \$1051.00 declared value capital stock tax imposed by Section 1200 of the Internal Revenue Code of 1939 for the year commencing July 1, 1938 and ending June 30, 1939, was not erroneously and illegally assessed and collected by respondent from appellant.

4. That the Conclusions of Law and the Decision of the District Court are not supported by any substantial evidence and the decision of the District Court is not in accordance with law.

IV.

ARGUMENT.

THE DECISION OF THE DISTRICT COURT.

The District Court held that the failure of appellant to exercise a right to demand deliveries of royalties in kind rather than in cash involved an affirmative act constituting the doing of business within the meaning

of the decisions of this Court in *Kettleman Hills Royalty Syndicate v. Commissioner*, 116 Fed. (2d) 382 and *U. S. v. Trust No. B-I*, 107 Fed. (2d) 22.

These cases hold that the existence of such a right, under the decision of the U. S. Supreme Court in the case of *Morrissey v. Commissioner*, 296 U. S. 344, 80 L. Ed. 263, conferred upon the trust in question the *power* to exercise a business judgment. These trusts were therefore held to be associations corporate in character, taxable under the provisions of the Revenue Laws defining taxable associations.

These cases, decided under a different statute under which the *power* to do business, rather than the *doing* of business, is the criterion of taxability, were held to govern the case at bar.

V.

SUMMARY OF ARGUMENT.

Appellant was not engaged in the carrying on or doing of business during the taxable year ending June 30, 1939 by reason of the fact that it had a right to demand delivery of royalty in kind. Although the right to exercise such a choice confers a power to act, the failure to exercise the granted option does not involve action. The capital stock tax imposed upon corporations which carry on or do business is not imposed upon appellant by reason of such failure to act.

VI.

ARGUMENT.

The question for decision is whether or not, Section Seven Corp., appellant herein, is subject to the payment of the declared value capital stock taxes imposed by Section 1200 of the Internal Revenue Code of 1939, as amended, for the year commencing July 1, 1938 and ending June 30, 1939.

Section 1200, subdivision a, reads as follows:

“For each year ending June 30, beginning with the year ending June 30, 1939, there shall be imposed upon every domestic corporation with respect to carrying on or doing business for any part of such year an excise tax of \$1 for each \$1,000 of the adjusted declared value of its capital stock.”

The tax is imposed if a corporation actually carries on or does business during any part of the taxable year. *The doing of business* and *not* the *power* of the corporation to do business is the controlling factor. Whether or not plaintiff is subject to the tax imposed, depends upon whether or not it actually carried on or did business during any part of the taxable year hereinbefore referred to.

The Commissioner of Internal Revenue in his regulations 64, Article 43, in force for the taxable year in question, specifies that a corporation shall not be held to be doing business under the capital stock tax act in a case in which its activities are limited to: “2. The disposition of the avails of property and the doing only of such acts as may be necessary for the mainte-

nance of its corporate status in a case in which the corporation either was organized for or has reduced its activities to the mere ownership and holding of specific property.”

The first income tax levied upon corporations was imposed upon the *carrying on or doing of business* and the question was early presented as to whether or not the receipt of rent or royalty from property and the distribution of such rent or royalty to stockholders constituted the actual carrying on or doing of business. A number of Supreme Court decisions establish that such activities do not constitute the doing or carrying on of business.

In *McCoach v. Minehill Ry.*, 228 U.S. 295, 57 L. Ed. 842, a railroad company had leased all of its property at an annual rental and was collecting the rental and distributing it. The corporation kept and maintained its offices and paid the usual and ordinary expenses incident thereto. In holding that the acts of the corporation did not constitute the doing of business under the Federal Corporate Tax Act imposed upon the actual carrying on of business, the Court spoke as follows:

“The distinction is between (a) the receipt of income from outside property or investments by a company that is otherwise engaged in business; in which event the investment income may be added to the business income in order to arrive at the measure of the tax; and (b) the receipt of income from property or investments by a company that is not engaged in business except the business of owning the property, maintaining the in-

vestments, collecting the income, and dividing it among its stockholders. In the former case the tax is payable; in the latter not."

In *U. S. v. Emery Co.*, 59 L. Ed. 825, 237 U.S. 28, a corporation was engaged in the collection of rent from a single lease and the distribution of this rental to its shareholders. In holding that the corporation was not engaged in or doing business, the Court stated:

"The claimants' characteristic charter function, and the only one that it was carrying on, was the bare receipt and distribution to its stockholders of rent from a specified parcel of land. Unless its bare existence as an intermediary was doing business, it is hard to imagine how it could be less engaged.

"Judgment affirmed."

In *Von Baumbach v. Sargent Land Co.*, 61 L. Ed. 460, 242 U.S. 503, a corporation was formed to acquire, operate and dispose of large tracts of timber land. Although a large portion of the land of the corporation was leased, the corporation during the year disposed of certain land and stumpage, rented and leased other portions of the land and allowed portions of the land to be used for school house purposes and public park purposes. The Court held that the activities of the corporation in selling property and stumpage, and granting leases, constituted the doing of business and in so holding the Court spoke as follows:

"It is evident, from what this Court has said in dealing with the former cases, that the decision in each instance must depend upon the particular

facts before the court. The fair test to be derived from a consideration of all of them is between a corporation which has reduced its activities to the owning and holding of property and the distribution of its avails, and doing only the acts necessary to continue the status, and one which is still active and is maintaining its organization for the purpose of continued efforts in the pursuit of profit and gain, and such activities as are essential to those purposes."

The question determined by the foregoing Supreme Court cases is the same question presented in any case where it is necessary to decide, under the capital stock tax act, whether or not a corporation is doing business; and the Courts have consistently followed the same doctrine in cases arising under the capital stock tax act.

See:

- U. S. Mercury Mines Co. v. Viley*, 20 Fed. Supp. 734;
- Rose v. Nunnally Investment Company*, 22 Fed. (2d) 102.

The same question was presented to the Circuit Court for the Ninth Circuit in the case of *U. S. v. Hotchkiss Company*, 25 Fed. (2d) 958, C.C.A. 9. The Hotchkiss Company instituted an action against the United States to recover capital stock taxes paid for the year ending June 30, 1924 and for the four years immediately preceding. The corporation had been organized for the sole purpose of owning and holding 20,000 acres of timber land in Del Norte County and reselling the whole at a profit. It issued bonds and

from time to time levied and collected assessments on its capital stock. In order to avoid condemnation proceedings, it sold a strip of land to Del Norte County for highway purposes for \$5000.00. It paid its secretary a salary of \$50.00 per month, and its president, \$150.00 per month. It maintained its corporate existence, but never sold any part of its land, other than the strip of land to Del Norte County mentioned above. In holding that the corporation was not subject to the capital stock tax, the Ninth Circuit Court spoke as follows:

“The sole question presented for decision is: Was the defendant in error carrying on or doing business during the period in question, within the meaning of the Revenue Acts? If so, the judgment should be reversed; otherwise, it must be affirmed.

The mere substitution of one mortgage or one form of indebtedness for another, the levy of stock assessments to pay taxes, and interest, the maintenance of corporate existence, the sale of a right of way for a public road to avoid condemnation proceedings, and the payment of nominal salaries to the secretary and president, did not, without more, constitute carrying on or doing business, within the meaning of the law. Of course, we must judge the activities of the corporation as a whole; but if it was not carrying on or doing business because of the activities mentioned, it has done nothing else, and was not subject to the tax, unless, as contended by the government, every corporation organized for the purpose of holding property for gain or profit is doing business, regardless of its other activities.

As said by the Circuit Court of Appeals of the Second Circuit, in *Eaton v. Phoenix Securities Co.*, 22 F. (2d) 497: 'We do not think that anything will be gained by an extended discussion of * * * this tangled subject.' Suffice it to say that, under the authority of *Zonne v. Minneapolis Syndicate*, 220 U. S. 187, 31 S. Ct. 361, 55 L. Ed. 428, *McCoach v. Minehill & Schuylkill Haven R. Co.*, 228 U. S. 295, 33 S. Ct. 419, 57 L. Ed. 842, and *United States v. Emery, Bird, Thayer Realty Co.*, 237 U. S. 28, 35 S. Ct. 499, 59 L. Ed. 825, we are of opinion that the defendant in error was not carrying on or doing business during the period in question within the meaning of the law.

Von Baumbach v. Sargent Land Co., 242 U. S. 503, 37 S. Ct. 201, 61 L. Ed. 460, *Edwards v. Chile Copper Co.*, 270 U. S. 452, 46 S. Ct. 345, 70 L. Ed. 678, and *Phillips v. International Salt Co.*, 274 U. S. 718, 47 S. Ct. 589, 71 L. Ed. 1323, are not in conflict with the earlier decisions, although they rather indicate that the rule of exemption will not be extended. See, also, *Lane Timber Co. v. Hynson (C.C.A.)*, 4 F. (2d) 666, 40 A.L.R. 1448; *Cannon v. Elk Creek Lumber Co. (C.C.A.)*, 8 F. (2d) 996; *United States v. Three Forks Coal Co. (C.C.A.)*, 13 F. (2d) 631; *Rose v. Nunnally Investment Co. (C.C.A.)*, 22 F. (2d) 102.

In *Lane Timber Co. v. Hynson*, *supra*, the Court said:

'It is defendant's contention that a corporation which does what its charter authorizes it to do is liable for the corporation tax, and that the plaintiff, because it was authorized to hold title to the land, and was doing so with the expectation of selling at a profit, was engaged in business. If a

corporation is not engaged in business, it cannot make any difference that what it is doing is authorized by its charter. Owning land is not doing business, nor is paying taxes. Most owners of land, whether corporations or individuals would be willing to sell at a profit. In our opinion, the mere fact that the plaintiff selected agents who made efforts to sell its land does not render it liable.'

From 1906 to 1924 the defendant in error and its predecessor in interest owned and held this tract of timber land as their only asset. During that period they made no use of the land, added nothing to it, took nothing from it, engaged in only such narrow activities as are incident to the ownership of property and it would be going very far to say that such corporations are carrying on or doing business within the meaning of a revenue law."

See also:

Sears v. Hassett, 111 Fed. (2d) 961, C.C.A. 1.

Under the foregoing authorities, none of the activities of Section Seven Corp., including the execution by it of rights of way under the circumstances presented, constituted the carrying on or doing of business within the meaning of Section 1200 of the Revenue Act.

The cited authorities are controlling unless their application to the case at bar has been changed by the decisions of this Court in *Kettleman Hills Royalty Syndicate v. Commissioner*, 116 Fed. (2d) 382, and *U. S. v. Trust No. B-I*, 107 Fed. (2d) 22.

The Revenue Act has always defined a corporation as follows:

“The term ‘corporation’ includes associations, joint stock companies and insurance companies.”

It therefore became necessary for the Courts to define the meaning of the term “association” and the leading case adopting such a definition is *Morrissey v. Commissioner*, supra. If the type of organization adopted by associates essentially resembles the corporate form, the association is taxable as a corporation, if in addition, it has the power to carry on or do business. Whether or not business is actually carried on is immaterial, if the power to carry on business is conferred upon the organization. *Power* to act, rather than *action*, determines taxable status, in such case.

In *U. S. v. Trust No. B-I*, a corporation owning oil properties was dissolved and its assets were distributed to trustees. The trustees had the power to sell the oil produced upon the land of the corporation, to otherwise protect the trust property and to sell, lease or release the property, as in their judgment, they deemed advisable. The trustees could drill wells at the expiration of the leases, could exploit the land as owners, and could release the entire premises.

In the *Kettleman Hills* case the trust had been organized to administer royalty rights in the Kettleman Hills area. The trustee had the power to collect and receive royalties for oil and gas, to sell oil and to do any and all things necessary to develop and

protect the property of the association. The association had the option to demand deliveries of royalties in kind rather than in cash. The Court held that the right to demand delivery in kind conferred upon the association the power to do business, making it a taxable association within the definition prescribed by *Morrissey v. Commissioner*. In both the cited cases, the question for determination was the existence of a *power* to carry on or do business. The question here presented *involving capital stock taxes* is whether or not appellant *actually engaged in business*. The test is whether or not the corporation does business; not whether or not it has the power to do business. Even though it may be said that the right to exercise a choice confers a power to act, it cannot be said that the failure to exercise the choice involves action. The distinction between the case at bar and the two cases hereinbefore cited is clearly pointed out in the case of *Sears v. Hassett*, 111 Fed. (2d) 961 C.C.A. 1. There a real estate trust was established to simplify the holding of the legal title to certain real property and to facilitate the sale and disposition of the property. Two questions were presented:

1. Whether or not the trust was an association taxable as a corporation under the income tax law; and,
2. Whether or not it was subject to the payment of capital stock taxes.

The Circuit Court of the First Circuit held that, although the trust was taxable as an association under the income tax law since it had the *power* to do busi-

ness, it was not subject to the capital stock tax for the reason that although it had the *power*, it was *not carrying on or doing business* within the meaning of the capital stock tax statutes. In so holding the Court spoke as follows:

“this is an excise tax not on the privilege of doing business during the year but ‘with respect to carrying on or doing business for any part of such year’. As the court held in *United States v. Emery, Bird, Thayer Realty Co.*, 237 U.S. 28, 32, 35 S. Ct. 499, 501, 59 L. Ed. 825, ‘The question is rather what the corporation is doing than what it could do’. In the case at bar the trustees many years ago had sold all the parcels of real estate but one; during the tax years now in question they were not engaged in real estate operations nor in the business of buying and selling securities. They acted merely as lessors of a single building under a long-term lease to S. S. Kresge Co. The lessees assumed all the burden of management, operation, upkeep and insurance, and paid the trustees a net rental plus taxes. The trustees received the rent, paid the taxes and mortgage interest, added semi-annually to a time deposit with the Massachusetts Hospital Life Insurance Co. for the purpose of building up a fund to pay off the mortgage at the expiration of the lease, and distributed the remainder of the rental income to the beneficiaries quarterly. In 1936 and 1937 the trustees were incidentally engaged in litigation with the lessee as to the right of the latter to terminate its liability by assignment of the lease.

It is recognized that ‘The case is exceptional in which the activities of a corporation for profit

do not amount to doing business within the meaning of the Act'. Article 42, Treasury Regulations 64 (1936 ed.). Article 43 of these Regulations recognizes as one of the exceptional cases 'the distribution of the avails of property and the doing only of such acts as may be necessary for the maintenance of its corporate status in the case in which the corporation either was organized for, or has reduced its activities to, the mere owning and holding of specific property'. In Article 32 of Treasury Regulations 64 (1934 ed.) it is said: 'The leasing of all the property of a corporation whereby it divests itself of all control and management thereof, or the sale of all the property of a corporation and the reduction of its activities to the mere collection of the proceeds of the sale on an installment plan, are other instances of retirement from business'.

We think the facts of the present case fall within *McCoach v. Minehill Ry. Co.*, 228 U.S. 295, 33 S. Ct. 419, 57 L. Ed. 842. See also *Zonne v. Minneapolis Syndicate*, 220 U.S. 187, 31 S. Ct. 361, 55 L. Ed. 428; *United States v. Emery, Bird, Thayer Realty Co.*, 237 U.S. 28, 35 S. Ct. 499, 59 L. Ed. 825. In the *McCoach* case a railway corporation had leased its road to another company and had retired completely from the maintenance and operation of the road. It maintained its corporate organization and was ready to resume possession of the property at the expiration of the lease. It collected and distributed to its stockholders the rental from the lessee. It also maintained a so-called contingent fund which involved considerable activity in investment and reinvestment in securities yielding an annual in-

come of over \$24,000. The court held that the corporation was not 'doing business' within the meaning of the statute. The dissenting justices thought that the investment activities of the corporation should be considered 'doing business' for profit. In this respect the McCoach case was a stronger one for the Government than the case at bar, where the trustees were not engaged in managing investments but merely made periodic deposits with the Massachusetts Hospital Life Insurance Co. to build up a fund with which to pay off the mortgage at the termination of the trust. The McCoach case has been distinguished on its facts in later cases. *Von Baumbach v. Sargent Land Co.*, 242 U.S. 503, 37 S. Ct. 201, 61 L. Ed. 460; *Edwards v. Chile Copper Co.*, 270 U.S. 452, 46 S. Ct. 345, 70 L. Ed. 678. It has not, however, been disapproved, and we must accept it as a binding authority. See *Kingkade Hotel Co. v. Jones*, D.C. 30 F. Supp. 508.

It follows that the district Court should have given judgment for the appellants in the amount of the capital stock taxes paid for the years in question, plus interest.

In the first case the judgment of the district court is affirmed. In the second case the judgment of the district court is vacated and the cause remanded to that court for further proceedings in conformity with this opinion."

If the distinction between the power to do business and the act of doing business is borne in mind, it is clear that appellant is not subject to the capital stock tax heretofore collected by appellee.

A corporation whose only business is collecting regular monthly rental or royalty payments from its lessees and distributing the proceeds to its shareholders, is not subject to the tax imposed upon corporations actually conducting business. It is the settled rule of the decisions of the Federal Courts that corporations whose sole activity is of this character shall not be subject to the declared value capital stock tax.

It is therefore respectfully submitted that judgment herein should be reversed with instructions to the District Court to enter judgment for plaintiff as prayed.

Dated, San Francisco,
November 2, 1942.

Respectfully submitted,

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